

ERM Symposium

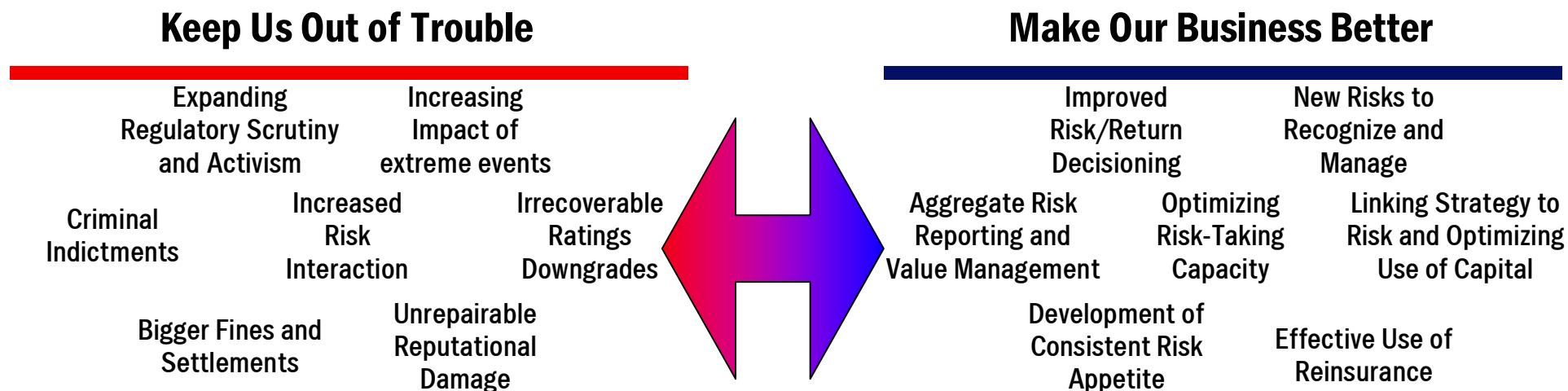
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Risk Appetite

March 28, 2007

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The Increasing Importance of Risk Appetite and Governance

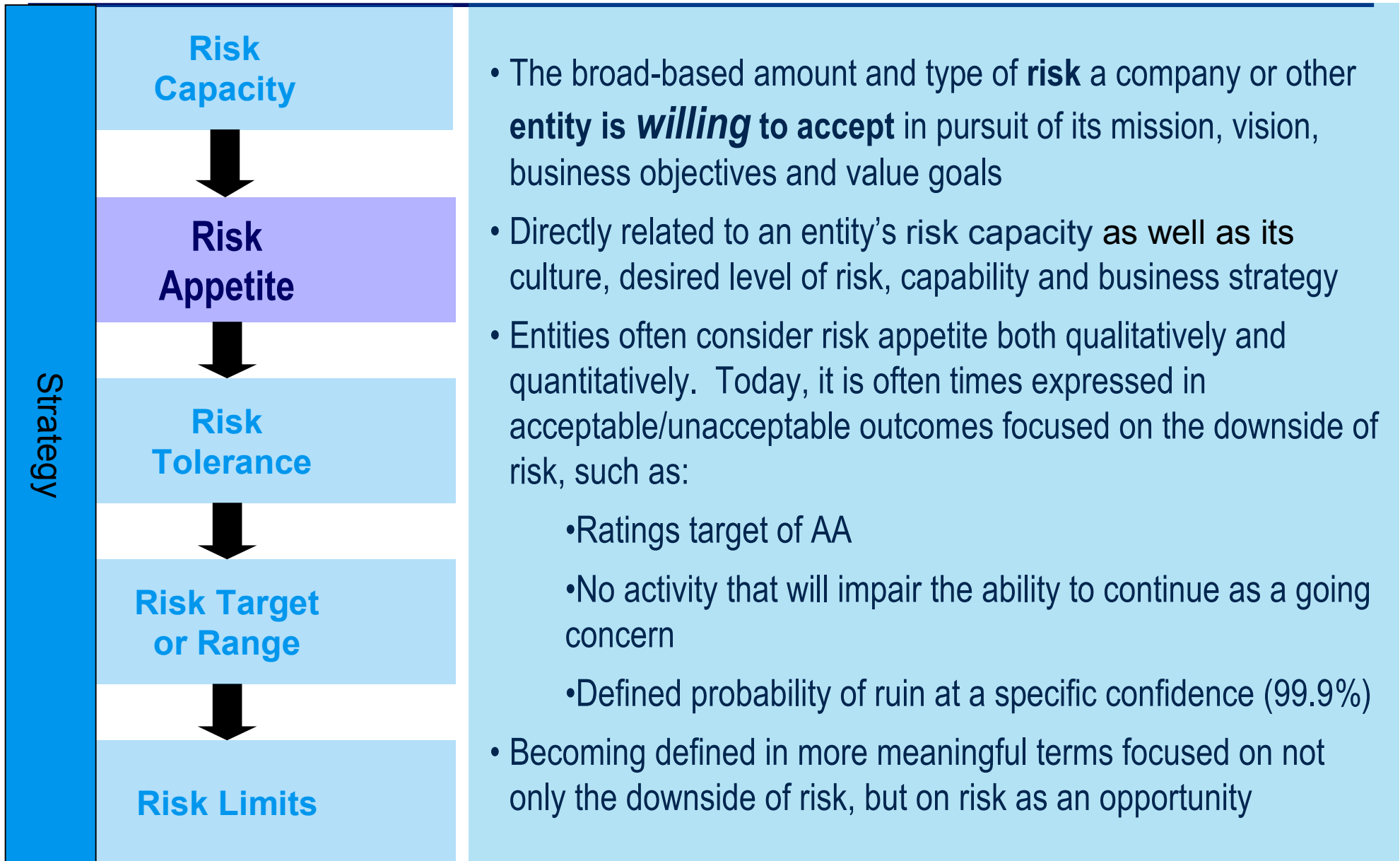


- ❑ Many of the failings of companies can be attributed to the acceptance of excessive risks, the poor management of those risks or a lack of clarity around the level of compensation expected for risks taken
- ❑ Most companies have not formally considered what their true appetite for risk is, accordingly, they do not have effective processes to ensure they operated within the expectations of key stakeholders
- ❑ The link between risk and strategic planning or business decision making is insufficient
- ❑ Risk appetite, tolerances, risk targets and limits are a critical element of prudent business management and an effective risk governance process, and need to be more than a statement, but something you live every day by how decisions are made and companies are managed

Risk Appetite, Tolerances and Limits



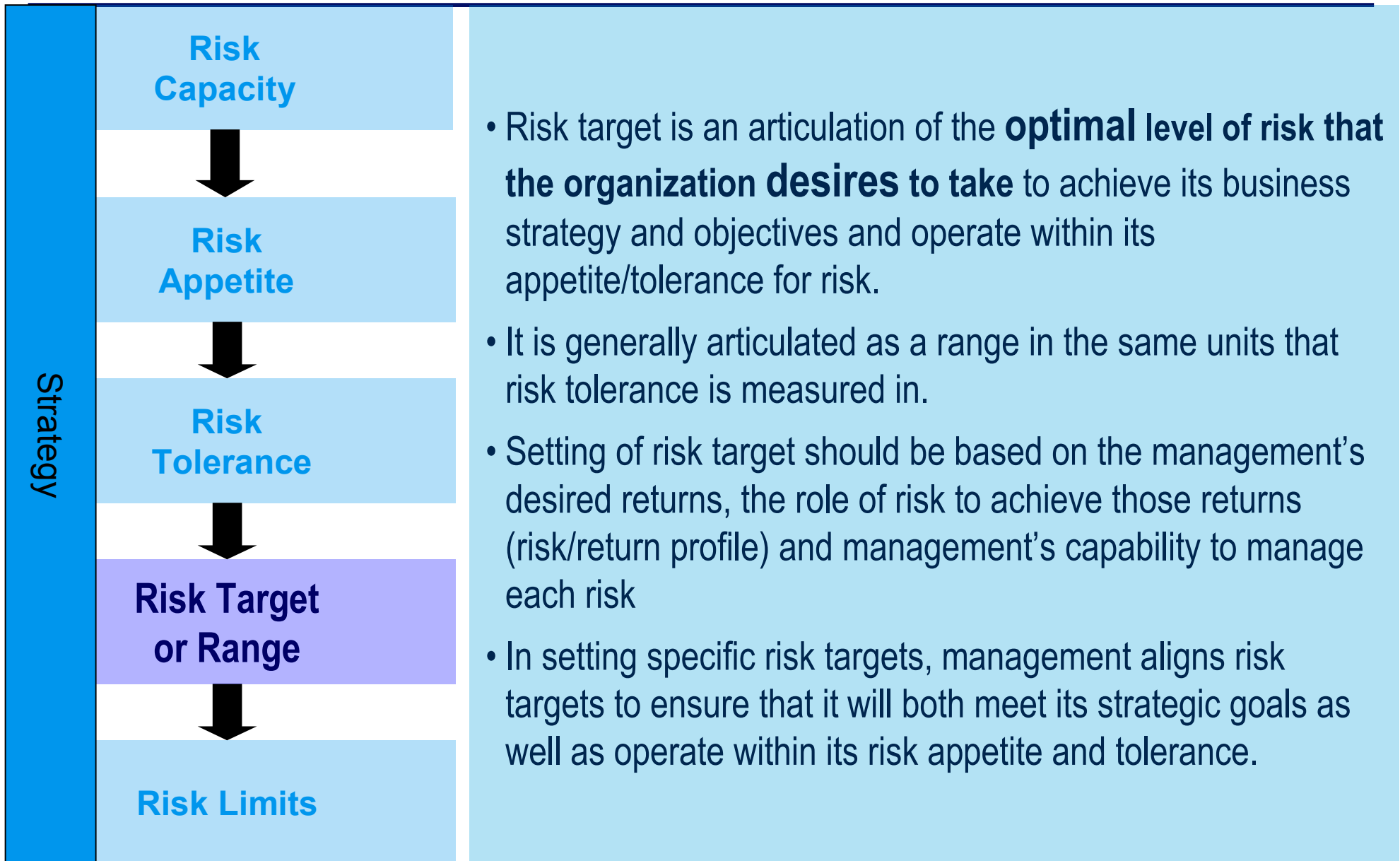
Risk Appetite, Tolerances and Limits



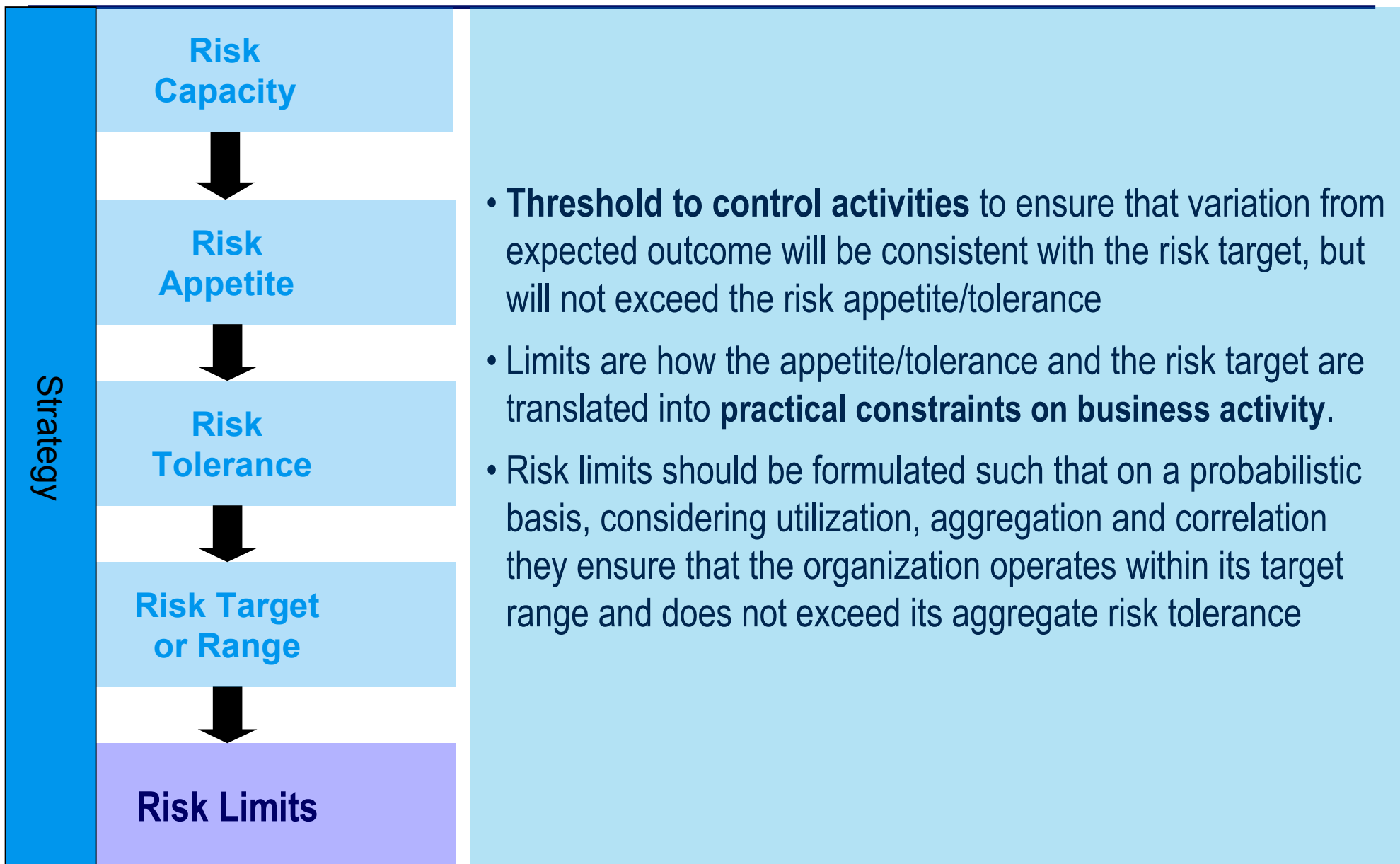
Risk Appetite, Tolerances and Limits



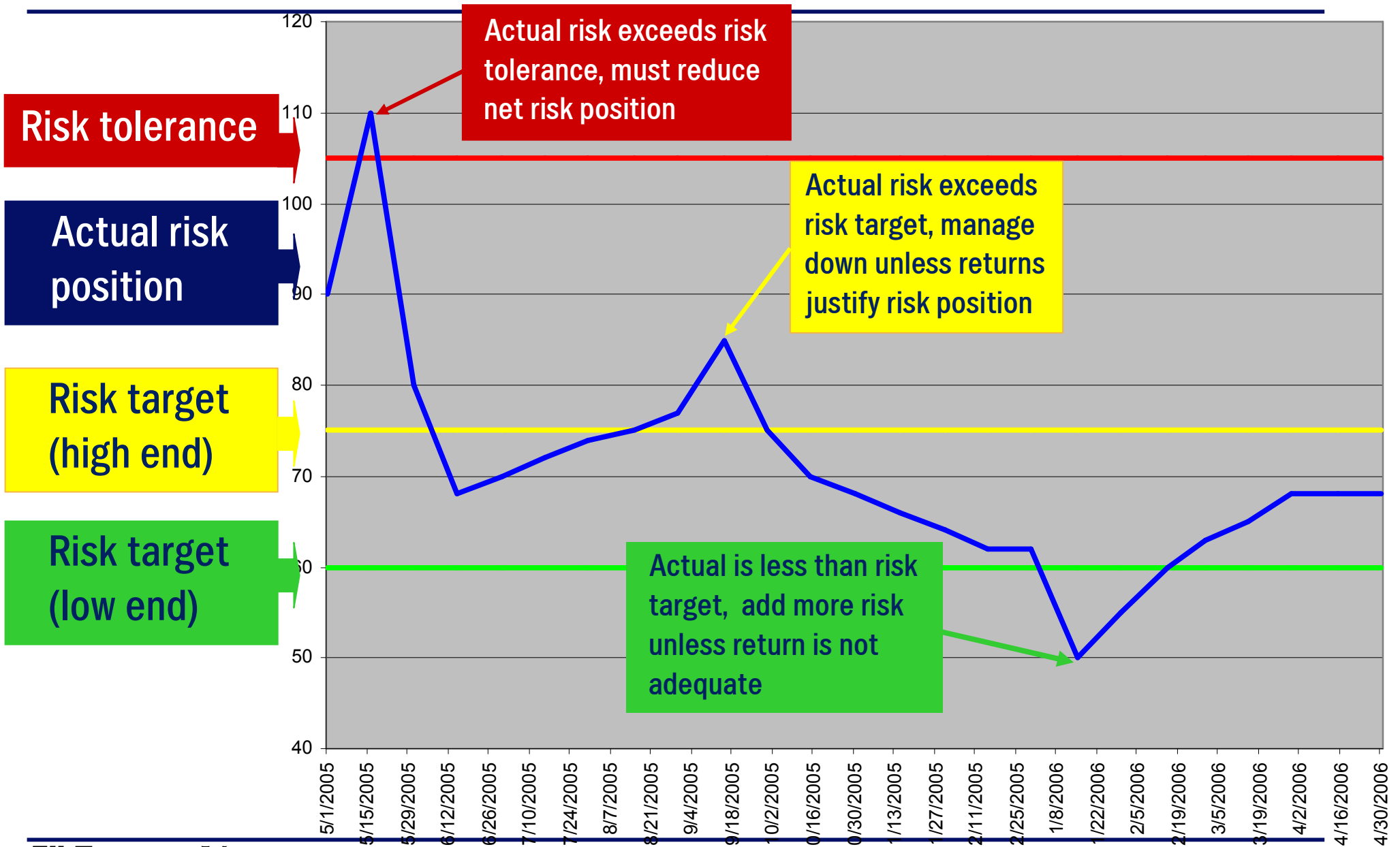
Risk Appetite, Tolerances and Limits



Risk Appetite, Tolerances and Limits



Risk Appetite/Tolerance/Target Example

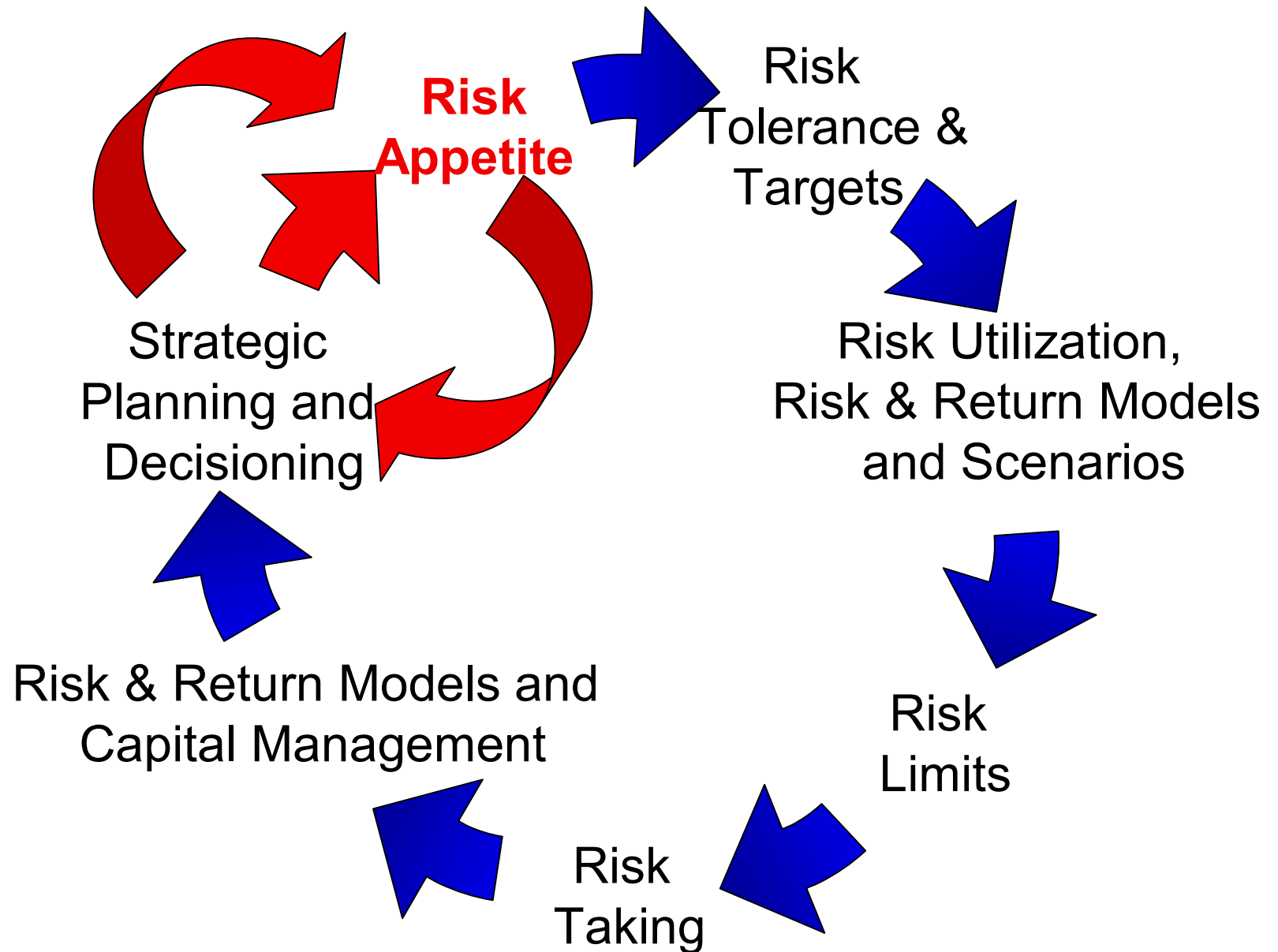


Why Do We Need A Risk Appetite, Tolerance and Risk Targets ?

- Provides an objective measure to act as a cornerstone for making both strategic and tactical decisions around risk, and can serve as the link between risk and strategic planning and business decision making
- Ultimate goal is not purely a governance objective, but a need for a tool to manage the business better
- Goals of setting clear tolerances and limits:
 - To give units a clear mandate from corporate as to what type and amount of risk to accept and manage
 - Enables effective management of the risks by placing optimized constraints on the type and volume of business written
 - Limits possibility of significant negative surprises
- Risk targets improve optimization of risk taking and enable value based risk management
 - Provides a guide as to how much risk should be taken
 - Provides a consistent guide to measure risk/return for decision making
- An effective risk appetite is a basic requirement of S&P's ERM framework, and necessary to achieve either a Strong or Excellent ERM rating

Risk Appetite Lifecycle

- Risk appetite, tolerance and limits are not static
- They must be updated with changes in strategy, the environment and market expectations
- Ultimately, they should be a key element in driving risk taking and in turn in performance measurement



Risk Appetite in Strategic Planning



Considerations in establishing Risk Appetite/Tolerance

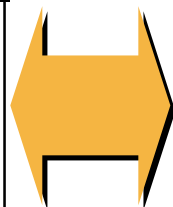
Identify Key Value Drivers to Protect or Support

Operating Environment

- Board & Stakeholders philosophy and expectations
- Company philosophy, culture and values
- Capital structure, liquidity and available capital
- Maturity of business and industry

External

- Investor/stakeholder/customer expectations
- Rating agency expectations
- Regulatory capital expectations
- Long-term market environment and expected level of industry sector risk
- Access to capital markets



Internal

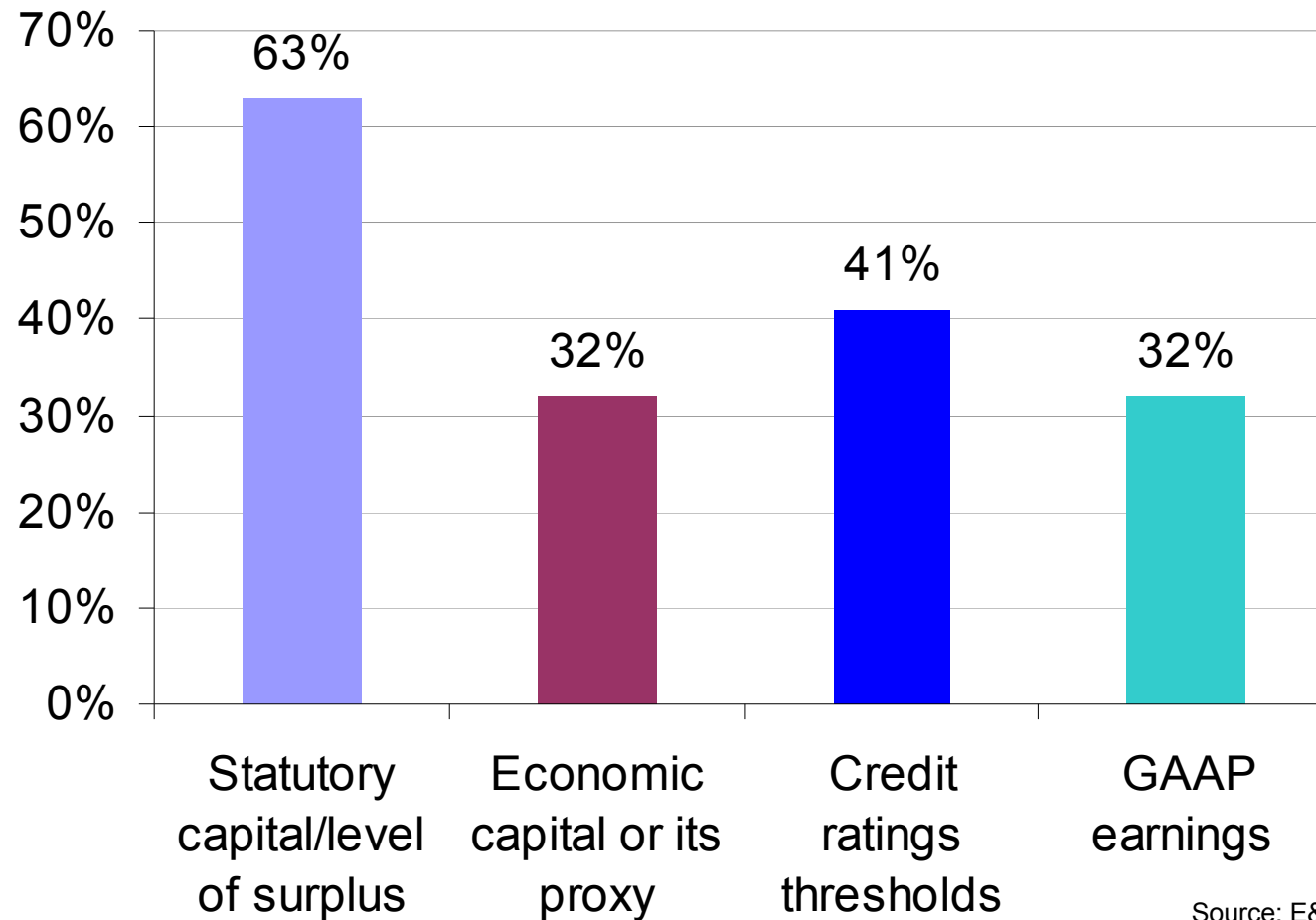
- Corporate business objectives
- Risk bearing capabilities, capacity, experience and risk awareness
- Business strategy and capabilities
- Effectiveness of risk management processes

What should not drive risk tolerance ?

- Competitors short-term actions
- Current market conditions
- Short-term earnings targets or performance goals

Risk Appetite Dimensions – Risk Leadership Roundtable Survey Results

Historically, organizations typically consider risk appetite based on effects across four general dimensions:



Source: E&Y Insurance Risk Leadership Roundtable

Risk Appetite Attributes to Consider



□ Risk Capacity

- Capital, surplus, credit ratings
- Maximum aggregate level of risk or concentrations of risk
- Maximum level of risk for each class of risk
- Core vs. non-core risks



□ Volatility

- Earnings
- Cash flow
- Economic value
- Other financial ratios



□ Value

- Risk adjusted return
- Hurdle rates for risks taken
- Economic Value created for risk taken



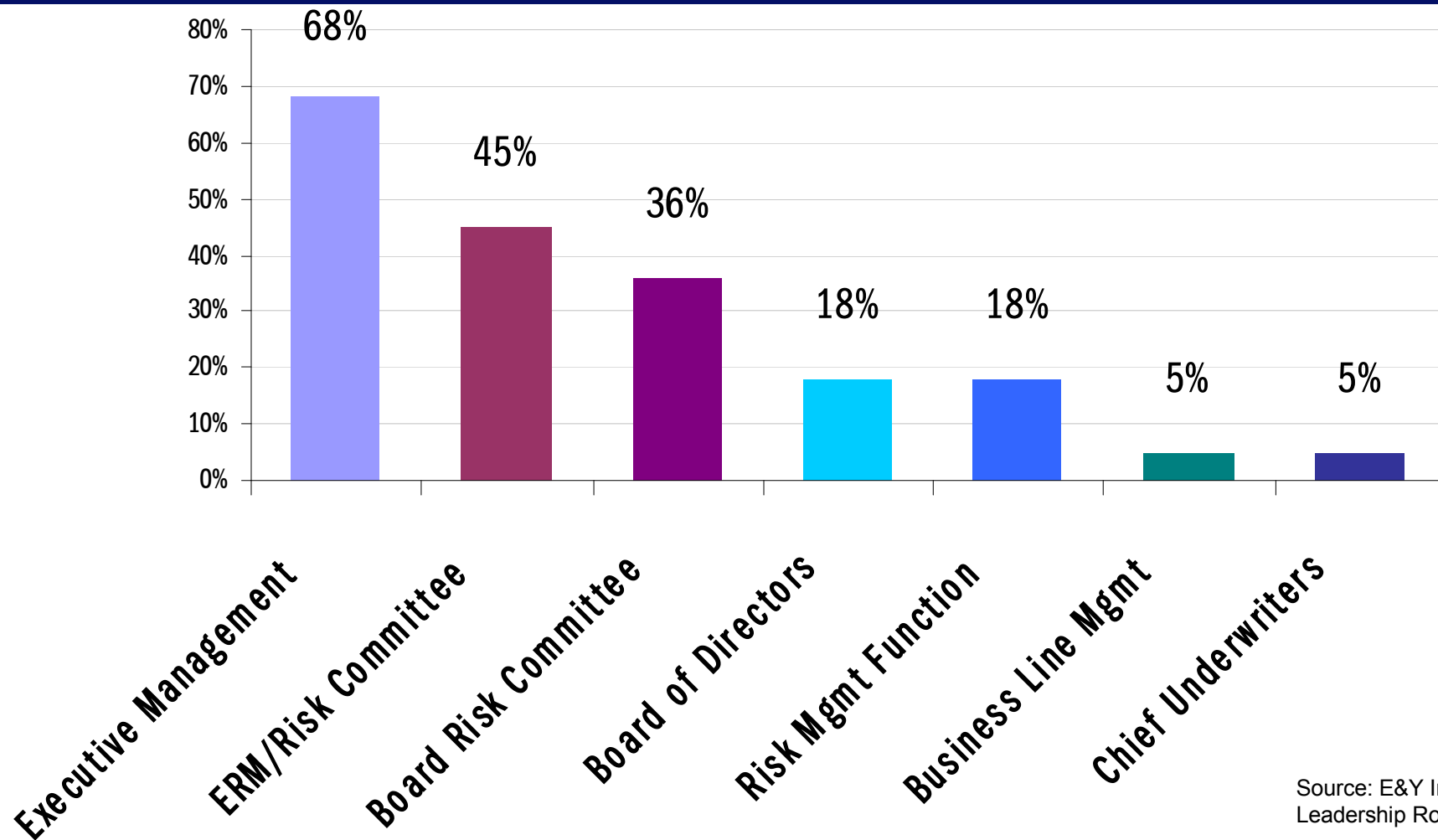
□ Risk Preferences

- Risks and activities outside of core mission, values or capabilities
- Reputation impact
- Customer impact

Attributes of Risk Appetite

- Risk appetite should be based on the expectations of its Stakeholders and management
- Risk Appetite should tie to the objectives of the of the company. It needs to be aligned with overall strategy, and strategy should be aligned with risk appetite
- Risk Appetite should support an integrated and portfolio view of risk.
- Risk appetite should support value creation and protect against value destruction
- Risk appetite should be calibrated to be consistent with the philosophy, culture, capabilities and capacity of the organization and its employees to manage the risk inherent in its current and potential business activities
- Risk Appetite should be developed based on a top-down/bottom-up feedback process whereby Business Unit limits and individual risk limits are cross-checked against overall Enterprise level appetite and risk tolerance

Who sets the risk appetite – Risk Leadership Roundtable Survey Results



Source: E&Y Insurance Risk Leadership Roundtable

From a corporate governance perspective:

- ERM department should propose the risk appetite
- Management should set the risk appetite
- The Board of Directors should challenge/approve the risk appetite

Success Factors in Setting Risk Appetite/Tolerance

- ❑ Process should be driven by executive management, facilitated by the CRO, involve key business executives and be driven by Board expectations and ultimately their concurrence
- ❑ Recognize different stakeholders have different tolerances; some are more focused on value protection, while others are focused on value creation
- ❑ Create an opportunity to focus on, and mechanism to protect, what creates and sustains the value of the organization
- ❑ Use corporate strategy, culture and risk capabilities to drive the level of risk appetite and tolerance
- ❑ Look to historical risk decision making and reactions to risk events to determine true appetite
- ❑ Avoid inward thinking by explicitly including perspectives of external stakeholders and regulators

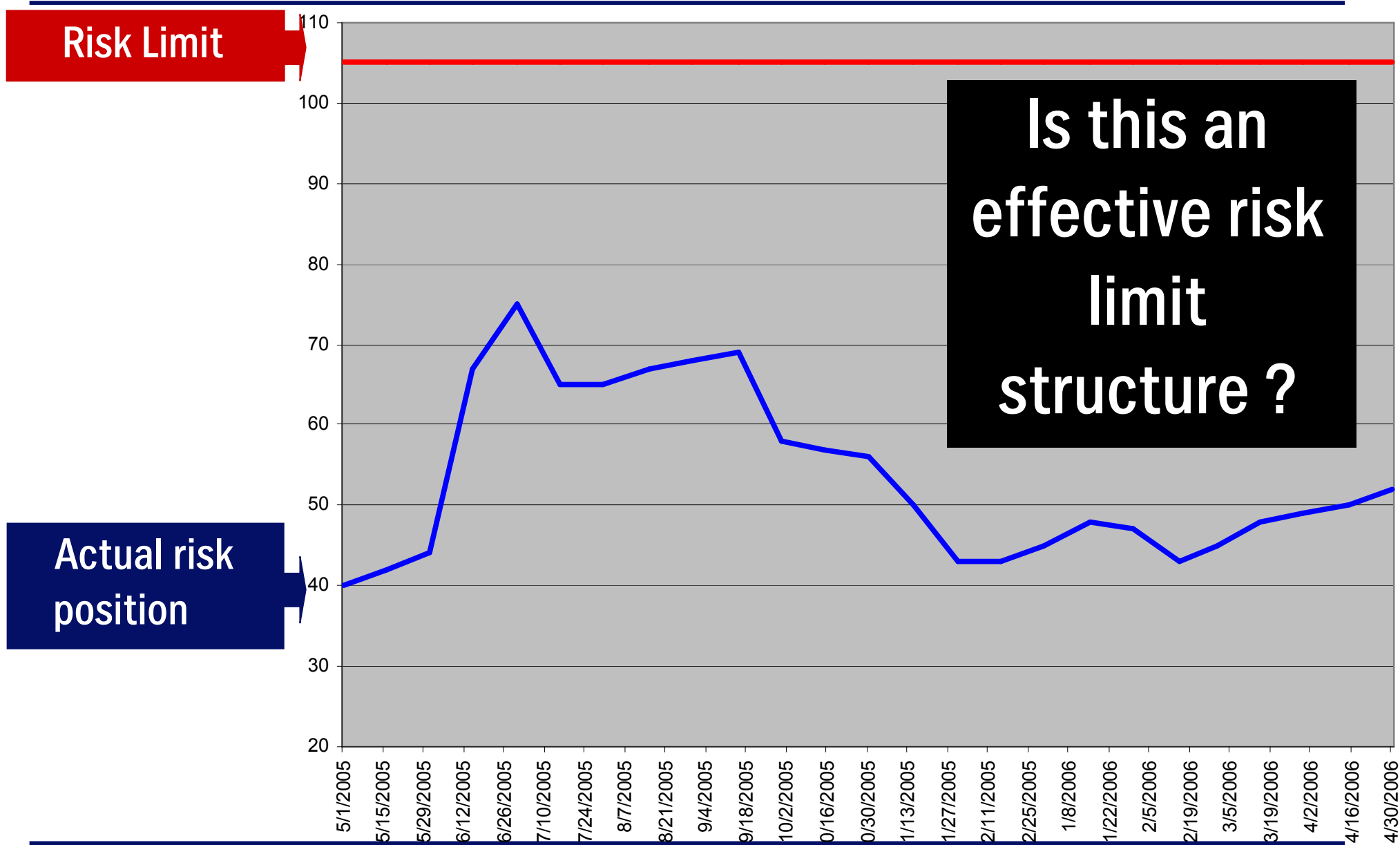
Success Factors in Setting Risk Appetite/Tolerance

- ❑ Integrate non-financial risks into risk appetite
- ❑ Differentiate between core vs. non-core risks
- ❑ Validate the viability of the business strategy and profitability of the company should it operate within the constraints of the risk appetite and tolerance
- ❑ Create as few measures as is practical that represent all critical elements
- ❑ Communicate risk appetite broadly to entire management team and business managers to ensure all actions of the organization contribute to achievement of the risk appetite/tolerance
- ❑ Make risk appetite a key element of strategic planning and corporate decision making
- ❑ Align risk limits, key indicators, strategic planning and risk reporting with risk appetite attributes and measures to communicate business results consistent with risk appetite and tolerance
- ❑ Recognize there is no “right” answer

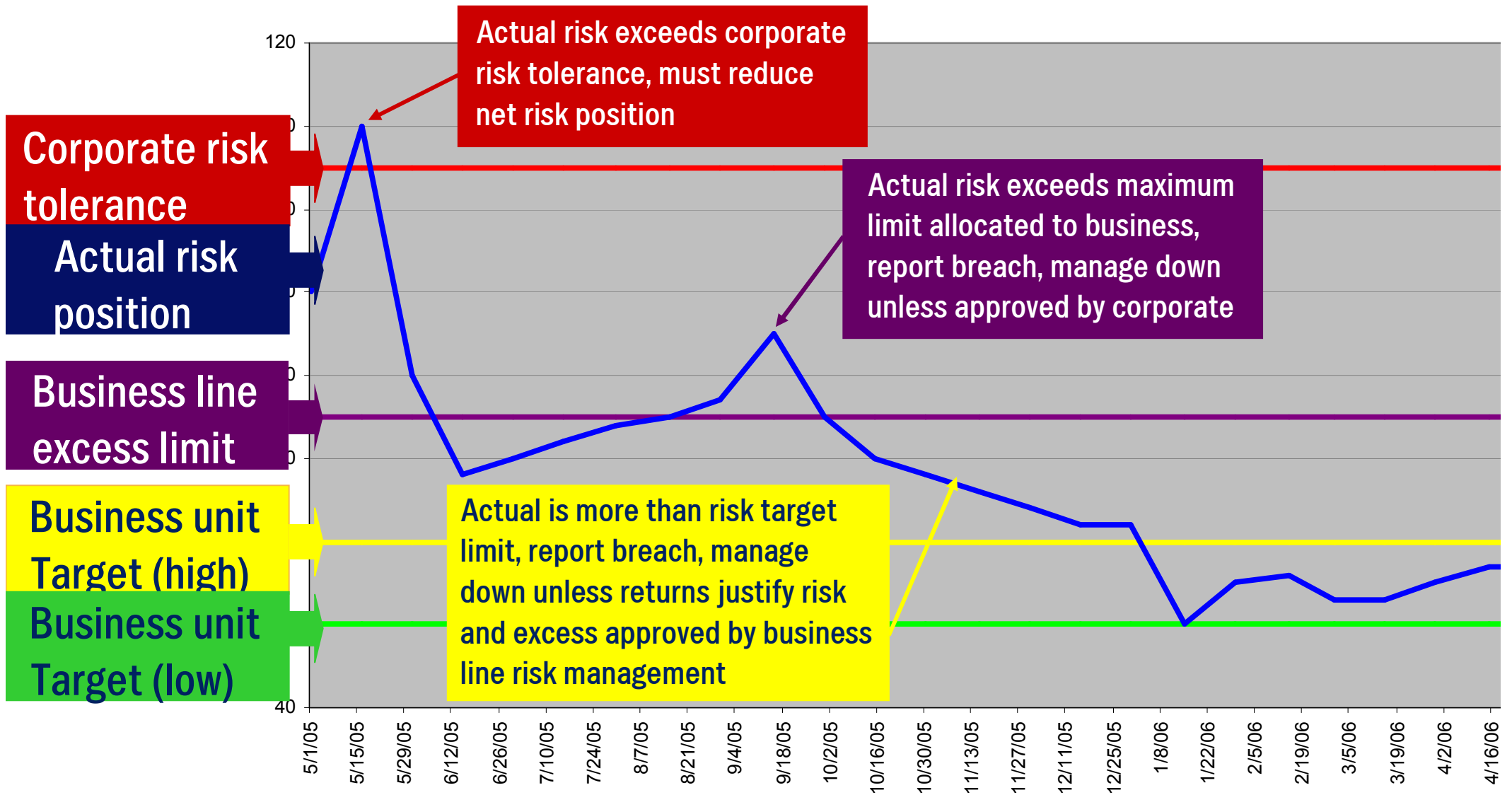
In summary

- ❑ Formalization of risk appetite, tolerance and targets is a necessary step in effective enterprise risk management and good risk governance
- ❑ Should be set working with Board and key stakeholders to set and manage within appropriate expectations
- ❑ Focus on what diminishes value as well as what creates and sustains the value of the organization
- ❑ Should be communicated broadly to management team to ensure all actions of the organization contribute to achievement of the risk appetite/tolerance
- ❑ Should include multiple measures

Common Risk Limits Structure



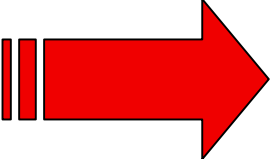
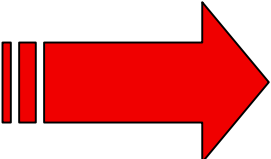
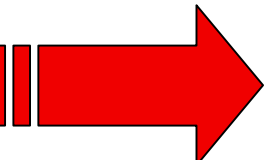
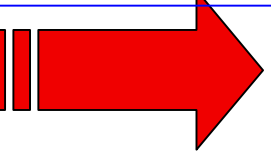
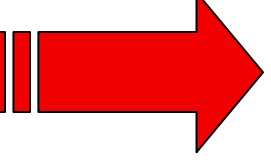
Operationalizing Improved Risk Limits



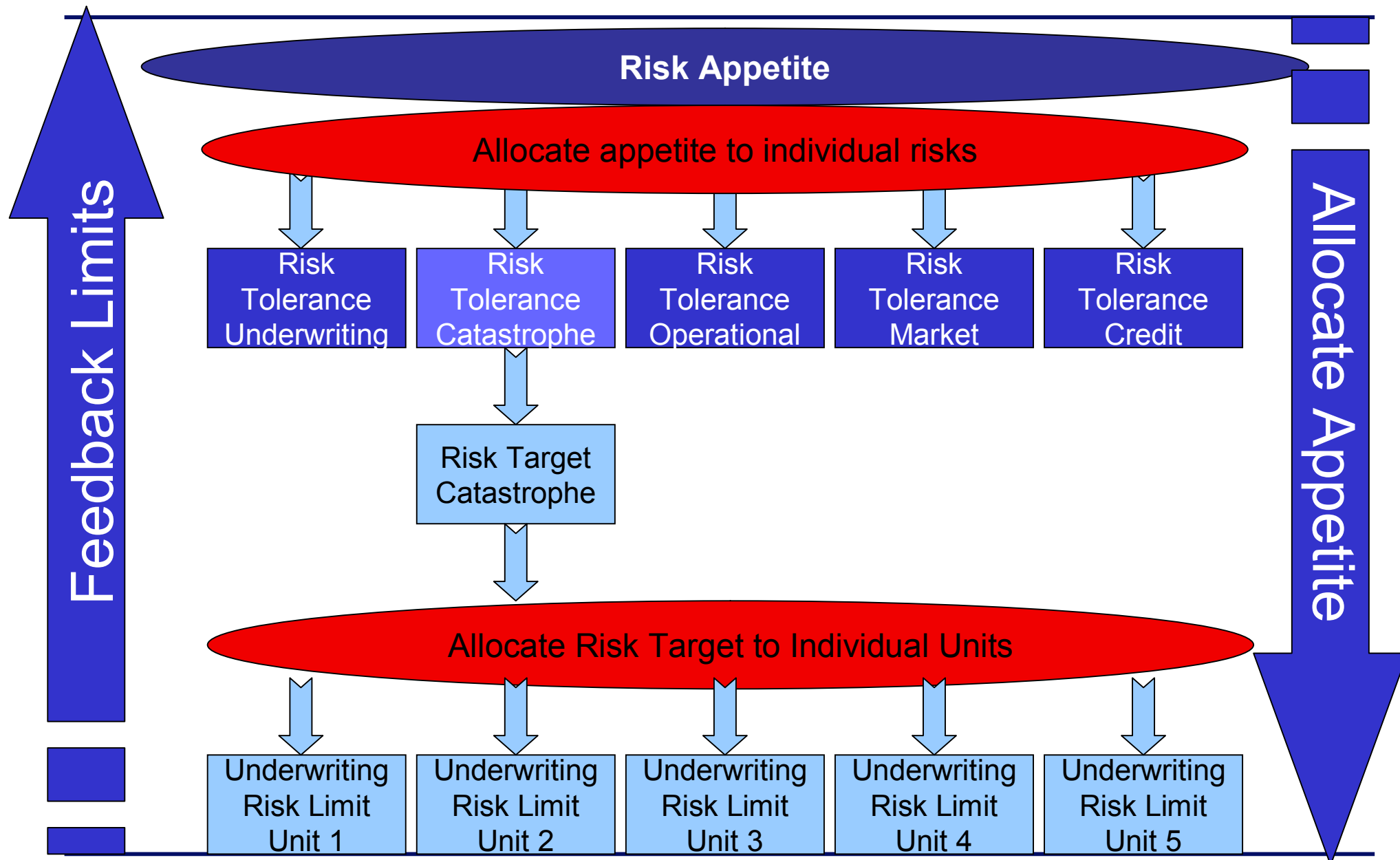
Can we improve how we manage and use limits?

- The current approach to limits in most organizations could be substantially enhanced
 - Not designed to optimize use of risk capacity
 - Little or no relationship to risk appetite/tolerance
 - Over allocated to adjust for under utilization, communication weaknesses and correlation
 - Common use of nominal or notional limits
 - Lack of monitoring and structured exception management and escalation processes
- The current ties between risk appetite and tolerances remain fuzzy in most organizations (Risk Leadership Roundtable):
 - 13% reported no formal linkage
 - 52% respondents said the linkage is qualitative (based on judgmental assessment of tolerances compared to appetite)
 - 26% said linkage was probabilistic with modeling of all tolerances at a defined probability compared to the appetite
- Less than half (43%) of companies define and measure risk limits on a consistent basis across the enterprise

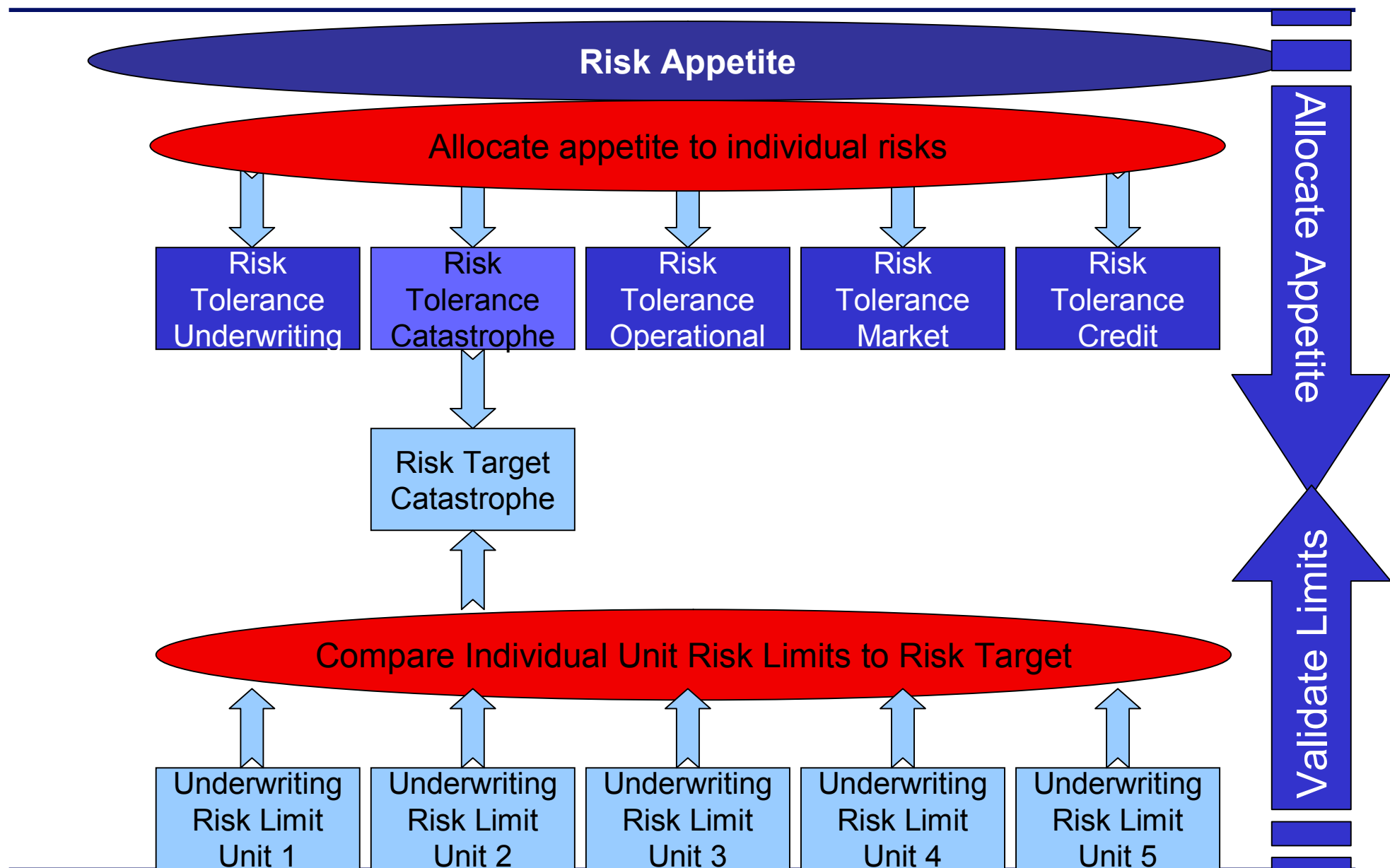
Issues with Existing Limit Approaches

Issue	Possible Solution/Response
Not designed to optimize use of risk capacity	 <ul style="list-style-type: none">□ Target limits<ul style="list-style-type: none">▪ Target limits with high and low bands based on the riskiness of the activity and expected returns□ Risk adjusted return based limits allocation<ul style="list-style-type: none">▪ Usage charges based on risk adjusted returns▪ Dynamic limit reallocation between segments, business units, and products based on risk/ return
Aggregation and relationship to risk appetite/tolerance	 <ul style="list-style-type: none">□ Risk modeled limits structure<ul style="list-style-type: none">▪ Model risk limits structure based on full usage, expected usage and actual usage
Over allocation to adjust for under utilization	 <ul style="list-style-type: none">□ Pooled limits with real-time utilization<ul style="list-style-type: none">▪ Technology makes use of pooled limits possible▪ Retained limits allow for greater utilization management▪ Periodic utilization adjustments to limits
Use of nominal or notional limits	 <ul style="list-style-type: none">□ Risk sensitive risk measures<ul style="list-style-type: none">▪ VAR, CAR, CfAR, sensitivity measures (greeks, duration, convexity)
Lack of monitoring/structured exception management and escalation processes	 <ul style="list-style-type: none">□ Formalized exception management model with proscribed escalation processes<ul style="list-style-type: none">▪ Pre-established limit “excess” approval tolerances

Cascading Appetite and Tolerance to Limits - Theory



Cascading Appetite and Tolerance to Limits - Practice



In summary

- ❑ Linkage of risk limits and risk appetite/tolerance is critical
- ❑ Limits should be viewed as tools of management to manage and control the business
- ❑ Tiered limits structures, with effective consideration of utilization, aggregation and correlation are necessary to an effective limits structure
- ❑ Limits should be designed to constrain the business in key areas of risk
- ❑ Targets should be created for core risks to provide a framework for risk optimization and consistent risk decisioning across the company
- ❑ Limits should not be changed merely because they will be breached, but because returns justify the level of risk and the aggregate risk is within the company's risk appetite/tolerance
- ❑ To be a tool, limits must be monitored, reported and enforced in a structured process

Questions

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